
DIVIDEND CONTROVERSY: A THEORETICAL APPROACH

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Abstract:

One of the major financial decisions for a public company is the dividend policy - the proportion in which the company decides to distribute profits to shareholders. The difficulty of the decision comes from the implications on firm value. There are conflicting points of view on dividend policy. Even if under ideal conditions (perfect markets) dividend policy is irrelevant (the theory of Modigliani and Miller), still the way in which companies behave shows that the dividend policy is relevant in practice. Market imperfections (taxes, information asymmetry, transaction costs) influence dividend policy. The aim of this paper is to present the major theories and findings related to dividend policy that can help managers to make their decision of profit distribution with a positive impact on the stock price.

Keywords: dividend policy, value of the firm, cost of equity, clientele effect, signaling effect

1. Some general aspects regarding dividends

Companies consider dividend policy an important decision because based on it the company decides what funds will go to shareholders and what funds are reinvested in the company.

What can a company decide to do with the cash flows it generates? A firm that has investment projects with positive net present value may decide to reinvest profits to finance these opportunities. Small and medium enterprises in the growth stage may be in a position to fully reinvest profits in order to expand. Mature, consolidated, profitable companies can be found in a position to generate more cash than they need for their projects or have viable financing alternative so that they can afford to distribute a part of profit to shareholders.

But what is dividend policy? Dividend policy is the division of earnings between: payments to shareholders and reinvestment in the firm. There is conflict between the two alternatives: paying out more is equivalent to less reinvestment and vice versa. Suppose the capital budget is limited to retained earnings, than:

- An increased payout ratio will decrease the investment budget, so there will be a loss of profitable opportunities.

- Higher dividends are equivalent to lower expected growth in earnings and dividends.

So, what is the effect of a change in dividends paid, given the firm's capital budgeting and borrowing decision? Suppose the investment decision is fixed: capital budget = 100, earnings (profits) = 100. In this case the options are:

- a) Finance with retained earnings = 100, external funds = 0
- b) Payout dividends = 40, retained earnings = 60, external funds needed = 40 (if the borrowing decision is given, external funds are obtained by issuing shares)

As a conclusion, dividend policy is a trade-off between retained earnings and paying out cash and issuing new shares.

There are several qualitative aspects that one should consider when designing a dividend policy. Here there is a synthesis:

1. Legal aspects are significant because they provide the framework within which to formulate the dividend policy. In this respect there are several rules:

- Creditors impose some limits in what concerns dividend payments (in order to limit shareholders compensation on the expense of creditors).
- Laws prevent from paying dividends if a company is insolvent or by doing so will become insolvent (solvency rule)
- Dividends must be paid out of present or past profit as reflected in balance sheet (net profit rule)

2. Liquidity of the firm. Cash dividends can be paid only with cash. Lack of cash implies no dividend payments. Dividend payments represent a signal provided by the company regarding the profitability and liquidity of the firm. Firms with strong cash positions are motivated to pay dividends for at least two reasons:

- shareholders compensation
- reduction of the cash position, in order to reduce the probability of a takeover

3. Financial needs and the financing alternatives are different over the lifecycle of the company.

Over the life cycle, the company has various financing alternatives. A growing company needs large funds and their access to capital markets is difficult, resulting in total reinvestment of profits. A young company has a zero payout ratio or a low payout ratio due to opportunities to invest, and more difficult and expensive access to capital. In contrast, a mature company can afford to distribute a portion of profits as dividends to shareholders, as its financing alternatives are more varied. A mature company has a higher payout ratio. Cash cows are paying dividends. Also, dividend policy depends on the cost of issue of debt and equity instruments. The smaller they are, the dividend policy can be more flexible. Lower cost of capital gives flexibility to dividend policy.

4. Control. To maintain control of the company, the profit is reinvested largely to avoid the issue of new shares and thus diluting the position of major shareholders. Shareholders may be reluctant to sell new shares. To not lose control, they will use at maximum retained earnings, ending in a low or no dividend payments.

5. Information effects. Any dividend payment is providing signals in the market. Managers are very careful in making changes in dividend payments

6. “Legal list”. Paying a dividend for a number of consecutive years may be a condition put on some institutional investors in order to be able to invest in a company. So if the company wants to be on such a legal list to benefit from having large investors, they have to have dividend payments.

How frequent are dividends paid and what is the payment procedure? In most cases there are quarterly payments. In what concerns the payment procedure there are several important dates:

- Declaration date: the board of directors declares formally the dividend
- Payment date: when the company sends the checks to the shareholders
- Holder-of-record date: the date when the stock transfer books are closed, when the company makes the list of shareholders that are supposed to receive the dividend
- Ex-dividend date: the dividend leaves the shares (usually 2 working days before the holder-of-record date)

Dividends can be paid in different forms: **cash dividends** (*regular cash dividend*: the company expects to maintain the payment in the future; regular + *extra dividend* or *special dividend* – may not be repeated), **non cash dividends** (*stock dividends* - example: 5%: 5 new shares for each 100 shares; *dividend in products*; *dividend reinvestment plans*: automatically reinvest dividends in shares, save issuing costs)

2. Theories and evidence regarding dividend policy

Similar to capital structure issues, there are a lot of research and studies regarding the company's dividend policy, but there is not a consensus in this area. There are pros and cons of distributing dividends.

There are mainly three different points of view:

- **The conservatives** consider that an increase in dividend will be followed by an increase in the value of the firm.
- **The radicals** consider that an increase in dividend will be followed by a decrease in the value of the firm
- **The middle-of-the-road** consider that the dividend policy is irrelevant

To understand the company's dividend policy and its implications on firm value, we will address first the theories initially developed by Modigliani and Miller in 1961, which considers dividend policy irrelevant under ideal market conditions. What means dividend policy is irrelevant? According to Modigliani and Miller (Modigliani and Miller, 1961), under ideal market conditions, dividend policy is irrelevant, does not influence the value of the firm, or the cost of equity (**Dividend irrelevance theory**).

Franco Modigliani and **Merton Miller** (MM) in 1961 developed this theory concluding that the value of the firm depends only on the income produced by its assets, not on how this income is split between dividends and retained earnings. The hypothesis of their theory is:

- No personal or corporate taxes.
- No issue costs or transaction costs.
- Financial leverage has no effect on the cost of capital.
- Investors and managers have the same information about prospects.
- *The distribution of income has no effect on the cost of equity.*
- Capital budgeting policy is independent of its dividend policy.

Modigliani and Miller are in fact saying that an increase in dividend requires issue of new equity to finance the investment budget being equivalent to more shares outstanding, so that the growth rate of dividend per share is reduced. The increased dividend is just offset by the lower expected growth, leaving the price of the share unchanged.

Many researchers believe that the findings of Modigliani and Miller are a correct view in the efficient markets hypothesis. However the real environment has imperfections that make dividend policy an important decision to the company affecting the company's value.

There are investors who prefer current versus future income and therefore they will appreciate more the companies that pay dividends. While Modigliani and Miller consider that investors are indifferent between dividend yield and growth rate because investors will anyway plan to invest dividends in the shares of the same company, **Myron Gordon** and **John Lintner** (GL) have brought debate on assumption number 5: cost of equity increases as dividend payout is reduced and developed the so-called **bird-in-the-hand theory**.

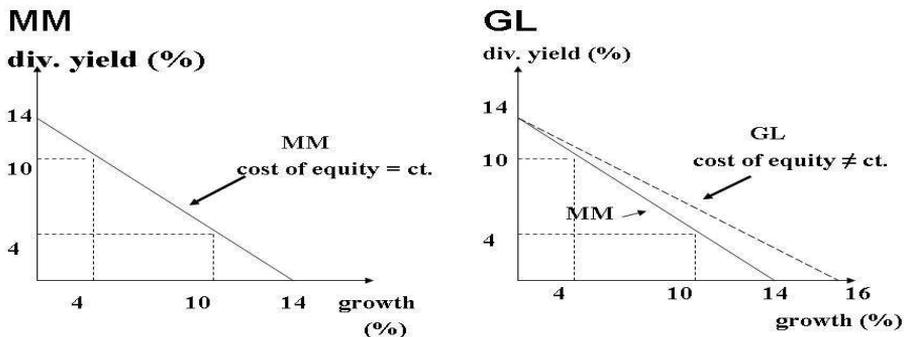
Gordon and Lintner have started from the cost of equity equation:

$$\text{Cost of equity} = \text{dividend yield} + \text{dividend growth rate}$$

and have considered that dividend yield component is more certain. Investors value more 1\$ in expected dividend than 1\$ in expected capital gain.

So, if **MM** consider that the required rate of return on equity is constant regardless from where it comes (from dividends or capital gain) – so there is no optimal dividend policy, **GL** consider that investors require a larger return if the capital gain component is larger (it is more risky) – more than 1% of additional growth is required to offset a 1% reduction in dividend yield.

MM vs. GL



There are also other theories related to dividend policy.

Dividend policy is important due to its **informational content**. Through the dividend policy, the managerial team is transmitting signals in the market that have effects on the stock price. Dividend payments (and even more their increase) offer signals to investors about the future earnings of the company. The signals refer to sound financial situation of the company, its liquidity and positive estimates of the management team in terms of business potential to generate profit in the future and to sustain the payment of dividends. Investors have expectations regarding the dividend payment. Depending on what dividend payment will be announced in reality, the stock price may change or not:

- If reality fits expectation regarding the increase in dividends, there will be no change in price.
- An increase in dividend above expectations will determine an increase in the price of the share.
- An increase in dividend below expectations will determine a decrease in the price of the share

In this respect, Modigliani and Miller argue that the change in dividends is signaling about future earnings and it is not showing the investors' preference for dividends.

Dividend policy has also a **clientele effect**. A certain dividend policy attracts a particular „clientele”, a particular type of investors, according to Modigliani and Miller. There are investors that prefer current income under the form of dividends, and there are investors that prefer profits to be reinvested in profitable projects that will be afterwards reflected in increased stock prices (capital gains are future income).

But how companies decide on dividend policy? John Lintner (Lintner, 1956) made a study in the '50s, interviewing managers from different companies on how they decide on the dividend payment. The main conclusions are:

- Firms have long run targets regarding the payout ratio: mature companies have higher targets than small companies.
- Managers focus on dividend changes, rather than on their absolute value.
- Managers smooth dividends. Dividend changes take place only on sustainable long run profits. Transitory profits don't affect dividend policy.
- Managers are reluctant to make changes in dividends if they have to revert afterwards.

So, the Lintner model can be summarized as follows:

Hypothesis: Firm always keeps its target payout ratio, t

$$D_1 = txEPS_1$$

So the dividend change will be

$$D_1 - D_0 = txEPS_1 - D_0$$

Dividend is a function of earnings per share, EPS. A change in earnings will determine a change in dividend. Shareholders prefer a steady progression in dividends. Even if earnings increase largely, the company will move only partway toward their target payment.

$$D_1 - D_0 = cx(txEPS_1 - D_0),$$

where c is the adjustment rate, and is below 1.

The adjustment rate is lower the more conservative the approach.

Based on Lintner's model we can conclude that dividends depend on:

- firm's current earnings
- dividend for previous year
- future prospects

Two thirds of the interviewed companies agreed that an increase in dividend implies an increase in stock price (the signal is of improved profitability and not of lack of investment opportunities).

3. Some conclusions

Theoretical considerations and empirical records highlight some questions (Shapiro and Balbirer, 2000) that managers must answer when deciding on the dividend policy:

1. *What are the investment opportunities the company has?* Dividend payment should be established in relation to long term investment opportunities and the financing alternatives that the firm has in order to maintain an optimal capital structure.
2. *What is the risk of the company?* Taking into account the negative impact on

shareholders when there are dividend reductions, the company has to ensure that the dividends announced have to be sustainable in time. Therefore, companies with unstable dividends tend to offer low dividends, and those with stable dividends, can offer larger dividends.

3. *Who are the shareholders of the company?* Dividend policy has to correspond to the preference of shareholders between dividend payments and capital gain.
4. *What is the liquidity of the company?* Dividends are paid in cash. Companies that have strong liquidity positions and easy and cheap access to capital can afford to pay higher dividends.
5. *Is control an issue to be considered?* If shareholders want to maintain control in the company they may be reluctant to issue new shares and therefore they favor the reinvestment of profit and a low dividend payment.

In general, what can be observed in practice is a **constant dividend policy**, with a constant growth because:

- Managers don't want to reduce dividends.
- Managers will try to offer stable dividends for several reasons:
 - variable dividends are risky,
 - dividends are used for current consumption,
 - managers can use dividend policy to signal about the company's profitability (dividends are cash payments)

There are many factors that influence the company's dividend policy. Each one has a different impact on management decisions. Some factors favor the payment of dividends, some not, and some favor stable dividend policy, in contrast to fluctuating dividends.

- *Factors favoring a high rate of dividend payment:* the type of investors (shareholders who prefer current income against future income); positive signaling effect they offer (firm liquidity); risk level (greater uncertainty may encourage valuing more current as compared to future income: the "bird in the hand" theory).
- *Factors favoring a low rate of dividend payment:* tax system, the type of investors (shareholders who prefer future income against current income); high potential of growth (existence of important investment projects that need financing); instable profits (the management does not want to reduce in the future dividends if profits are no more high enough); low liquidity of the company (not enough cash to pay dividends)
- *Factors favoring paying a fluctuating dividend:* the use of the residual dividend policy (management favors investment opportunities using reinvested profit at maximum and paying dividends only if there is profit left over).
- *Factors favoring a stable dividend:* shareholders preference to obtain stable income, to count on; improved credit ratings; signaling effect.

In summary, there are several pros and cons dividend payments (Ross, Westerfield, Jaffe and Roberts, 2003):

- Pros:
 - Paying cash dividends can amplify the good company's results with an impact on the stock's value.
 - Dividends may attract institutional investors that prefer some returns in the form of dividends.
 - Stock price is increasing as dividend payments are announced.
 - Dividends absorb excess cash flows and reduce the agency costs that appear due to the conflicting interests between managers and shareholders.
- Cons:
 - Dividends are taxed as income.
 - Dividends payments may reduce internal sources of funds. Dividends payments may determine the company to give up to investment projects with positive NPV or to finance these projects with more expensive capital.
 - Once a dividend payment is announced, reducing it in the future may have a negative effect on the stock price.

An optimal payout ratio can not be established through quantitative methods. There are some qualitative aspects that are in favor of a low or a high dividend payout ratio. Dividend policy should weigh investment opportunities, dividends and capital structure.

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